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SUBJECT: Mongolia Experiences Highest Inflation in over a Decade

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ULAANBAATA 00000686 001.2 OF 003

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¶1. (SBU) SUMMARY: Mongolia is experiencing its highest inflation rate in over a decade as consumer prices have so far risen 14% in 2007 largely due to skyrocketing fuel, wheat and meat costs. Prices for gasoline, taxi fares, flour and even the national dish huushuur (fried meat dumplings) have doubled in the past six months. Prices are also rising for key imports (compounded by the depreciation of the Mongolian Tugrik against the Chinese Yuan), administrative fees, utilities costs, transportation, education and health services. Some local economists argue that the price surges, which they say are the result of worldwide inflation and temporary glitches in meat supply, should be fully absorbed by the economy next year hailing the return to mid-single digit inflation in 2009. Nevertheless, with just over six months to go until national elections, Parliament and the Bank of Mongolia (BOM) are furiously trading accusations that each failed to react quickly enough to avert the inflation crisis. Meanwhile, the World Bank has warned that Mongolia's economy is at risk of overheating as demand for goods and services appears to have exceeded the economy's physical capacity to deliver them. If the GOM fails to control current expansionary fiscal and monetary trends (increased government spending, excessive wage increases, and generous welfare outlays), long-term inflation could become systemically and psychologically entrenched. END SUMMARY.

Food Prices Drive Highest Inflation Rate Since 1997

¶2. (SBU) According to officials at the Bank of Mongolia (BOM),

year-end inflation numbers for calendar 2007 could top 14%, primarily driven by food items which comprise 41% of Mongolia's Consumer Price Index (CPI) consumption basket. This is nearly triple the targeted inflation rate of 5.5% outlined in Parliament's amended national budget earlier this year, and represents the highest year on year consumer price increase in over ten years (Note: Modest price drops in November/December have led some economists to predict a year end inflation rate closer to 13%, still a ten year high). Mongolia suffered triple digit inflation in the early nineties after the collapse of the socialist economy, but the rate has since been brought down to an annual average of 7.2% from 1998 through 2006. The inflation rate for 1997 was recorded at 20%. According to BOM estimates, price hikes for food accounted for 70% of the total inflation rate; education 8%; transportation 5%; health 4.5%; utilities 6%; and other 6.5%. Since April 2007, the CPI growth rate increased at a rate of over 50% per month.

This Bread Needs No Yeast: Flour Prices Jump 40%
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¶3. (SBU) Global inflation and the Tugrik's depreciation against the Yuan have driven prices up for all imported foods. Prices for vegetables from China, for example, were up 22.5%; the price of flour imported from Russia increased by 40%. Mongolia's bread and cereals accounted for 3.3% of the 14% year-on-year total. Drought conditions in the provinces of Khentii, Selenge, and Tuv caused 2007 domestic wheat production to decline, reducing supply and placing further upward pressure on prices. According to GOM estimates for 2007, total demand for wheat will reach 298,468 metric tons (mt), only 121,200 mt (or 40%) of which will be met by domestic producers. Mongolia expects to import 91,071.43 mt, mostly from Russia, leaving a supply deficit of 27% or 81,715.32 mt.

Not-So-Happy Lunar New Year?

¶4. (SBU) Despite higher prices, flour is flying off store shelves. One flour producer told Econoff that the situation was preventing his company from building up reserve stockpiles of flour in advance of Lunar New Year (February 8-10), when demand normally soars. "This year will be a tough Lunar New Year holiday," he said.

¶5. (SBU) In response, lawmakers are now circulating draft legislation that would waive the import tax and VAT on imported wheat and grains from Russia for one year to ease prices. However, Russia's recently levied 10% export tax on wheat and grains would likely negate any relief that Mongolia's tax waivers might provide. According to press reports, Russia's Agricultural Minister recently announced that his country is ready to supply 250,000-300,000 mt of grain to Mongolia "at optimal prices" to help stabilize local bread prices. A formal offer is expected to be announced during the current visit of an official Russian delegation to Ulaanbaatar. The Russians have also reportedly offered guidance on how to stabilize prices.

The Unkindest Cuts: Meat Prices Soar 21%

¶6. (SBU) Most meat consumed in Mongolia is produced domestically. In September, meat prices were up 21 percent from the same month a year earlier, due to a convergence of four factors: drought conditions earlier this year; a growing tendency among herders to raise more profitable cashmere-producing goats; alleged price fixing among grey-market meat suppliers; and a rise in demand as net income increases. However, since September, meat prices have declined slightly, dropping 4%. In an effort to rein in price hikes, the Ministry of Food and Agriculture (MOFA) organized a meeting with meat suppliers and other stakeholders, who agreed to reserve 8,000 mt of meat in the coming year and keep the price of meat from exceeding Tugrik 2,100 per kilogram. Local residents report that the current average cost of a kilogram of meat is 50% higher than a year ago. (NOTE: Post's FSNs report that their usual weekly grocery basket prices have risen 30-40 %.)

Dramatic Rise in Fees, Utility Costs

¶7. (SBU) Public and private university tuition fees have jumped by more than 20% this year. Hospital services (room charges) rose 76% during the same period. In April 2007, water tariffs were increased by 74%, on average. (Note: Prices for education and services have been kept down for the last several years by the GOM, fearing public protests, and do not remotely reflect real costs. The price increases in this case reflect pent-up needs to pay for long-deferred maintenance and to provide relief for institutions that have had to absorb input cost increases.)

Monetary Growth and Increased Demand Fuels Inflation
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¶8. (SBU) According to the BOM, money supply (broad money, or M2) increased by 46.4% or US$608 million over last year's figures. BOM officials say mining inflows, remittances, and other commodity inflows are flooding liquidity into the Mongolian economy, and the BOM's efforts to mop it up by stepping up issuances of bank bonds appears to have little effect. The economy has simply expanded beyond the BOM's current issuance limits. Issuing US$30 million in bank bonds, for example, has had little impact considering the economy has doubled in size over the last five years.

¶9. (U) Increased consumer demand is being driven by a number of

factors: expanding government consumption; increases in public wages and social welfare transfers; sustained remittances from Mongolians working abroad; and a 5% VAT cut along with the reduction for most Mongolians of their personal income tax. Increased earnings and expected annual pay raises combined with falling interest rates have encouraged Mongolians to borrow at record levels to purchase such big ticket items as property and oversized SUVs (a status symbol in Ulaanbaatar). This, in turn, is generating more money in the economy by providing cheaper access to liquidity. Loans outstanding increased by 70.9% compared with last year, reaching US$110 million, of which 3.4% were deemed nonperforming. Meanwhile, the country's average saving rate rests at a paltry 6%.

Government Spending Soars

¶10. (SBU) Year-on-year government spending has grown exponentially, further stoking inflationary fires: 62% in 2006; 55% so far in 2007; and a proposed 80% for the 2008 budget. Generous welfare payments to new couples, mothers, and children, as well as 30% salary increases for civil servants have become an annual ritual, fueling increased consumer spending/demand. A BOM official told the DCM that many government workers went out and promptly spent the GOM's 30% pay hike well before it was actually granted, creating a spending splurge and price surge. Unfortunately, supply has failed to keep pace as the country's creaking infrastructure struggles to rush imported goods to markets (reftel).

Comment: Getting Beyond the Blame Game

¶11. (SBU) Parliamentarians have lambasted the BOM for not reacting quickly enough to the inflation crisis, which has become a thorn in an otherwise rosy economic picture. The BOM, having successfully squashed the previous decade's annual double-digit trend and its psychological underpinning amongst the public, responds that it has limited power to control fluctuating prices, and that Parliament's expansionary fiscal policies are the real culprit. The truth lies somewhere in between. Politics is driving Parliament's urge to spend while inflationary concerns have the BOM wanting to act more cautiously. Unfortunately, the lack of complete political independence has prevented the BOM from aggressively tackling inflation. If there is any hope of staving off long-term inflation, both sides will have to sit down and map out a policy that could very well be politically unpalatable, but necessary. The GOM will need to think hard about continuing its policy of increases in civil service wages (usually followed in lock-step by the private sector)

and social entitlements, which are directly contributing to inflationary pressures and are politically difficult to roll back.

¶12. (SBU) The BOM and the GOM together will also have to seriously consider taking the politically difficult measure of raising interest rates, to discourage lending and borrowing. But with Parliamentary elections drawing near, and Mongolians screaming that rates are already high enough (at around 20% per year), such a move seems highly unlikely. END COMMENT

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